The Harvard Law School
Corporate Governance Forum

Supreme Court rejects post-merger stockholder claims

Posted by Theodore Mirvis and Paul Rowe, Wachtell, Lipton, Rosen & Katz, on Thursday March 26, 2009 at 9:00 pm

(Editor's Note: This post is based on a client memo by Theodore N. Mirvis, Paul K. Rowe and David A. Katz of Wachtell, Lipton, Rosen & Katz.)

In an important decision, the Delaware Supreme Court has firmly rejected post-merger stockholder claims that directors failed to act in good faith in selling the company, even if it were assumed that they did nothing to prepare for an impending offer and did not even consider conducting a market check before entering into a merger agreement (at a substantial premium to market) containing a no-shop provision and a 3.2% break-up fee. *Lyondell Chemical Corp. v. Ryan*, C.A. 3176 (Del. Mar. 25, 2009). The en banc decision, authored by Justice Berger, is a sweeping rejection of attempts to impose personal liability on directors for their actions in responding to acquisition proposals, and reaffirms the board's wide discretion in managing a sale process.

The Court of Chancery had refused to grant summary judgment on claims that the directors of Lyondell had breached their duty of loyalty by failing to act in good faith in conducting the sale process. Lyondell's certificate of incorporation included an exculpatory provision, as permitted by Section 102(b)(7) of the Delaware General Corporation Law, that shielded the directors from personal monetary liability for any alleged duty of care violations but not for duty of loyalty violations. The Court of Chancery found the board to be independent and disinterested, but held that the directors' "unexplained inaction" when it appeared that the company would be put "in play" by a Schedule 13D filing created an inference that the directors may have consciously disregarded their fiduciary duties and failed to act in good faith in violation of the duty of loyalty.

In considering the claim under the *Revlon* standard requiring that the board seek to get the best price available in selling the company, the Supreme Court found that the lower court had misapplied the law in three respects: first, it imposed *Revlon* duties before the board had decided to sell the company or a sale had become inevitable; second, it misread *Revlon* as creating a set of specific requirements to be satisfied during the sale process; and third, it treated an arguably imperfect effort to sell the company as equivalent to "a knowing disregard of one's duties that constitutes bad faith."

The Supreme Court rejected the view that *Revlon* duties arise simply because a company is "in play," holding: "The duty to seek the best available price applies only when a company embarks on a transaction – on its own initiative or in response to an unsolicited offer – that will result in a change in control." The Court found that the board had appropriately exercised its business judgment by taking a "wait and see" approach in response to a Schedule 13D filing indicating that a party was interested in acquiring the company. The Court ruled that *Revlon* duties only arose when the directors chose to begin negotiating the sale of the company. The decision thus again makes clear that a board has no duties under *Revlon* to seek the "best price" in a sale or other transaction simply because a stockholder or other potential bidder tries to put the company "in play."

Rejecting the view that *Revlon* requires a board to follow one of three paths in a sale process (conducting a pre-agreement auction or an active post-agreement market check, or demonstrating sufficient market knowledge to excuse the failure to do either), the Supreme Court confirmed that "[n]o court can tell directors exactly how to accomplish that goal [of getting the best price in a sale], because they will be facing a unique combination of circumstances, many of which will be outside their control." Applying that critical admonition, the Court found it insufficient to call into question the directors' good faith the facts that the directors did not press for a higher price, did not conduct an auction or even a limited market check, approved a merger in less than a week while meeting for only seven hours in total, and agreed to deal protections that were considerable, albeit not unusual or preclusive. As Delaware law has long recognized, failure to conduct a pre-signing market check is entirely consistent with *Revlon* duties which can be served by other means, such as an appropriate fiduciary-out in the merger agreement. There is no single "blueprint" (or exclusive list of blueprints) that a board must adhere to in structuring and responding to an acquisition proposal.

The key to the Supreme Court's opinion was its unremitting focus on the effect of the charter exculpation provision foreclosing liability for duty of care claims, leaving only the possibility of duty of loyalty claims based on a failure to act in good faith – which requires a court to find a "conscious disregard" of "known duties." The Court made clear that hindsight debate about whether directors should have done something more or differently will not suffice to create a possibility of post-transaction personal liability:

> [B]ad faith will be found if a "fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties." The trial court decided that the *Revlon* sale process must follow one of three courses, and that the Lyondell direc tors did not discharge that "known set of [*Revlon*] 'duties'." But, as noted, there are no legally prescribed steps that directors must follow to satisfy their Revlon duties. Thus the directors' failure to take any specific steps during the sale process could not have demon strated a conscious disregard for their duties. More importantly, there is a vast difference between an inadequate or flawed effort to carry out fiduciary duties and a conscious dis regard for those duties.
>
> Directors' decisions must be reasonable, not perfect. "In the transactional context, [an] extreme set of facts [is] required to sustain a disloyalty claim premised on the notion that disinterested directors were intentionally disregarding their duties." . . . Only if they knowingly and completely failed to undertake their responsibilities would they breach their duty of loyalty.

The Supreme Court's opinion is a powerful statement that courts appreciate the complex decisions directors must make in selling the company, and will not allow post hoc process attacks to be deemed indicative of bad faith. Stockholders can still seek a preliminary injunction against a merger. But disinterested, independent directors will not face the threat of personal monetary liability unless truly egregious circumstances are shown in which the directors consciously disregard their known duties by utterly failing to attempt to obtain the best available sale price.

In this fundamental sense, the Supreme Court's decision fully implements Delaware's legislative policy, reflected in Section 102(b)(7), of protecting directors from personal liability for what are essentially duty of care claims, whether pleaded in that form or not. The need for that legislation was itself created by the Court's 1985 decision in *Smith v. Van Gorkom*, imposing personal liability on directors for failing to devote sufficient care to approval of an arms-length, premium-to-market merger agreement subject to an open stockholder vote. *Lyondell* shows that the legislative response to *Van Gorkom* has worked as intended: the Delaware courts will not permit plaintiffs to plead around it.